

## MARKET REPORT

### SO WHAT'S NEXT?

The tone for the month was set when bullish Chinese PMI and Australian GDP data helped markets rise by over 2% on the day, while poor employment and construction numbers out of the USA were largely ignored. This type of market behaviour is quite typical of what investors have to contend with at present – conflicting data that sees the market taking a one-sided view, leading to large moves in one direction in a short space of time. For most of 2010 the market has been stuck in a fairly broad trading range, driven largely by the sentiment swings from conflicting data.

The positive global sentiment also saw the Rand strengthen against most major currencies, closing below the R7 / \$ mark at R6.983 - an appreciation of over 5% on the month. The strength in the Rand was also helped by offshore takeover proposals of two local companies by global counterparties. Firstly there was the proposed HSBC purchase of Nedbank (effectively taking over the Old Mutual stake in the company) and secondly, the Wal-Mart offer for Massmart (which controls brands like Makro and Game). The Wal-Mart deal is particularly significant as it has the possibility to redefine the retail market in South Africa with the entry of one of the world's largest retailers.

Bond markets too were positive, with the South African All Bond Index advancing 0.76% on the month. Investors continue to be positively surprised by inflation, which is driving bond yields down and bond prices up. The expected 50 basis points rate cut in September was received and the debate is now on as to whether there will be another 50 basis points cut before the end of the year.

Another key factor influencing markets in September was the clarity received out of Basel as to the future of the banking world. Essentially, while banks are going to have much more stringent capital requirements going forward, the decision to allow banks a significant amount of time to adjust to the new rules, gave the market a significant boost.

Markets will no doubt continue their 2010 roller-coaster ride as we head into October. For now the sentiment remains positive, but as we have seen, this can swing dramatically on seemingly insignificant news. While a double dip recession does not seem the most unlikely outcome at present, the economic recovery remains fragile and over-bullish investors may well find themselves questioning their position in future economic data releases. ■

#### The Blue Ink funds produced the following performance to 30 September 2010

	1 month	3 months	6 months	12 months	2 years	3 years
Big Oak	1.06%	1.78%	4.16%	12.04%	22.01%	14.13%
Blue Ink-ubator	0.02%	3.82%	7.86%	17.06%	38.47%	51.72%
Blue Sky	1.03%	2.81%	3.85%	7.84%	7.99%	0.94%
Evergreen	0.02%	3.30%	5.14%	12.36%	22.84%	30.65%
Redwood	0.12%	2.20%	3.68%	9.43%	13.37%	12.40%
ALSI	8.74%	13.28%	4.02%	21.12%	30.45%	6.97%

### Dear Clients



At the Annual Africa Investment Conference, it was reported that Africa's potential is only beginning to be realized by global investors, many of whom are looking to diversify revenue streams and market risk. Activity is on the increase and mega-deals are on the cards – HSBC's buy-out of Nedbank, the Wal-mart bid for Massmart and an offer from Nippon Telegraph & Telephone for Dimension Data.

More positive news is the attractive opportunities offered by African stock markets. The Boston Consulting Group stated that the rate of return on foreign investment in Africa is higher than any other developing region and that an Africa strategy should be part of long term planning.

Steven van Jaarsveld, one of our Blue Ink Global analysts provides insight into the continuing debate – hedge funds or equities. And we chat with the team from KADD – Kevin, Ali, Danie and David. Blue Ink incubated two of the KADD funds, which have proved to be star performers.

The September performance of the Blue Ink funds was driven to a large extent by the Long / Short equity strategies, which returned more than 2% on the aggressive side and 1.6% on the conservative side.

Until next month!

**Esmarie Strydom**  
CEO, Blue Ink Investments

# DEFENSE IS THE BEST OFFENSE!

Steven van Jaarsveld - Analyst, Blue Ink Global Investments



What would have been your call a decade ago? Hedge funds or equity markets? Let's investigate and see how they fared...

In the left corner, with 1,500 stocks from 24<sup>1</sup> of the world's largest capital markets, it's the MSCI World Index<sup>2</sup> (MSCI). In the right hand corner with 671<sup>3</sup> fund of fund managers<sup>4</sup>, it's the HFRI Fund of Fund Composite Index (HFRI FOF).

Let's begin by separating the myths from the facts and in doing so, get these indices into the same "weight class".

## Round 1, myth 1: Hedge funds are unregulated

Most of the established hedge fund providers are regulated at a manager level. 86% of the managers in the Blue Ink global

watch list are registered by the United States Securities Exchange Commission (SEC); the Financial Services Authority (FSA) in the UK, or both. Most of the managers that are not registered have applied in the interim or are planning to in the very near future.

## Round 2, myth 2: Hedge funds are very risky

Hedge funds provide uncorrelated, superior diversification and superior downside protection to equities. This is not a very difficult point to prove - one only has to look at the statistics over the past 10 years.

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**“**.....  
**...clearly the HFRI FoF had superior protection to the downside...**  
 .....  
**”**

The school of finance teaches you in "Investments 101" that greater risk = greater return. In the chart "MSCI World vs. HFRI FOF over the past 10 years" (data from January 2000 to August 2010) however, the data proves this statement incorrect.

The HFRI FOF (in blue) had an annualised US\$ return of 3.69% against a volatility (risk) of 5.61%. Over the same time period, the MSCI (in red) had an annualised US\$ return of -0.82% against a volatility of 16.74% over the same time period.

Clearly the HFRI FOF had superior protection to the downside with the worst 12-month performance of -21.37% compared to the

MSCI drawdown of -48.41%. Although the MSCI had a greater upside with a best 12-month return of 50.94% compared to the HFRI FOF with an upside of 15.58%, the protection in the drawdown periods has made the greatest difference as will be illustrated in a later point.

## Round 3, myth 3: Hedge funds charge excessive & extravagant performance fees

Traditionally investment managers have levied a flat fee for active management regardless of the level of performance delivered, which is the same as what long-only managers charge. Over and above this, hedge funds also charge performance fees which can account for a substantial proportion of the manager's remuneration. These fees align the manager and the investor's interests as they can only be charged when positive returns are generated above a specified benchmark.

## Round 4, myth 4: Hedge funds have long lock-up periods

Hedge funds have liquidity profiles ranging from very liquid to very illiquid funds. As a rule, the Blue Ink Global portfolio is structured in such a way so as to blend these different liquidity profiles in a portfolio that can be fully redeemed on a quarterly basis which conforms with the industry norm.

## Round 5, myth 5: Hedge funds lack transparency

Since the market crash in 2008, transparency within the hedge fund space has greatly improved and the majority of the managers on the Blue Ink Global watch list are priced daily.

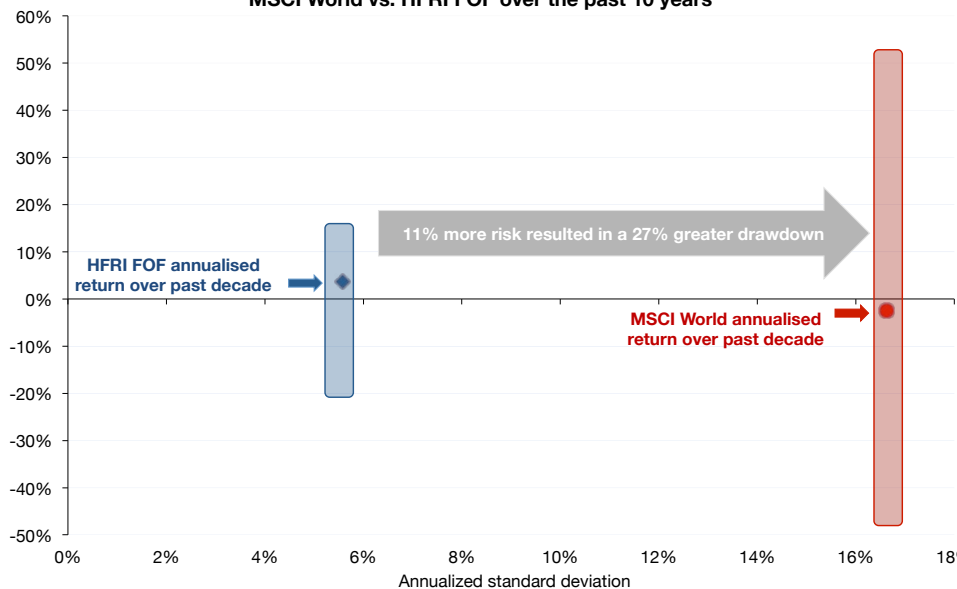
.....  
**“**.....  
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So the discussion above has levelled the playing field and placed hedge funds and equities in the same "weight class". Both hedge funds and equities have played out five rounds and have taken a few blows.... it's now time for the final round.

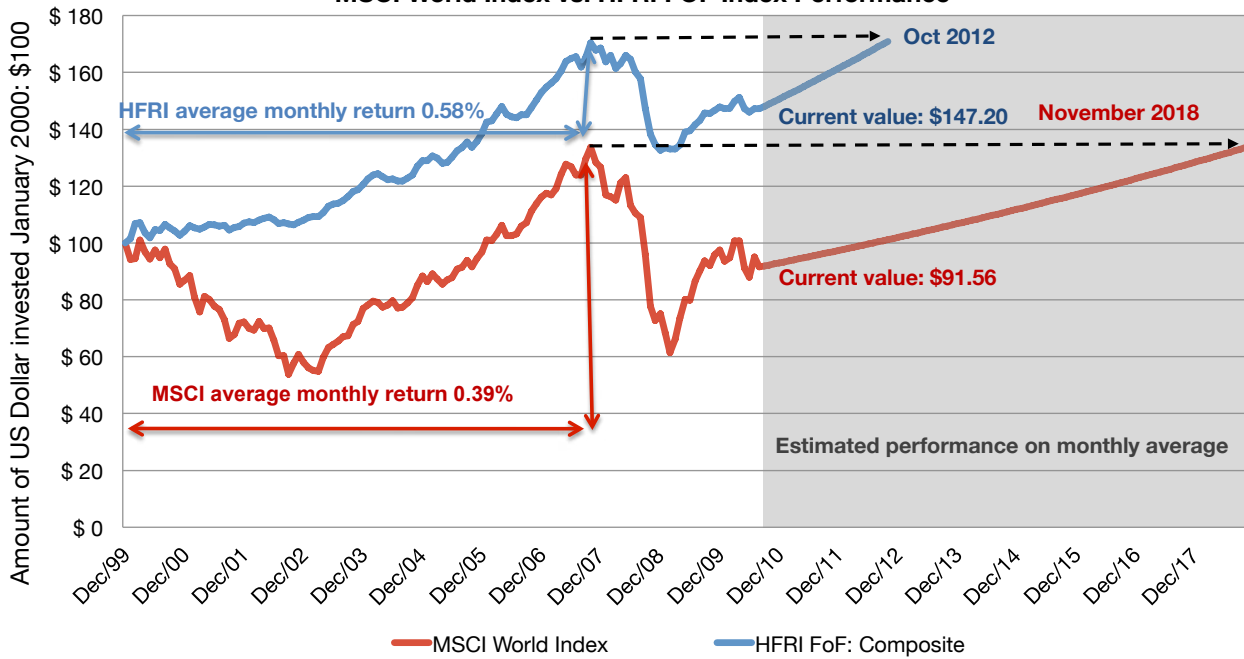
## Round 6: Performance

As discussed in "Round 2" hedge funds have had superior performance to equities over the period from January 2000 to August

MSCI World vs. HFRI FOF over the past 10 years



## MSCI World Index vs. HFRI FOF Index Performance



2010, which is clearly illustrated in the chart: MSCI World Index vs. HFRI FOF Index Performance. As you may have noted, the upside of the MSCI is far greater than that of the HFRI FOF. However, what separates the men from the boys, is drawdowns.

“.....  
**...the crux of the matter is  
 downside protection...**  
 .....

If one had invested \$100 in the MSCI in January 2000, the current value at the end of August 2010 would have been \$91. However, If one had invested in the HFRI FOF, one would have a value of \$147 at the end of August 2010. The major difference between the two lies in the protection to the downside.

Because the HFRI FOF did not have drawdowns as large as that of the MSCI, it was able to “make up ground” a lot faster than the MSCI. For example – looking at the average monthly performance of both indices from January 2000 to the market highs in October 2007, the average of the HFRI monthly performance was 0.58%, compared to 0.39% for the MSCI. Plotting this performance on the expected future returns of the two indices to create an estimate of when they could reasonably be expected to reach their high water marks, one could expect the HFRI FOF to reach its

previous high by October 2012, whereas the MSCI would only reach its high water mark six years later in November 2018.

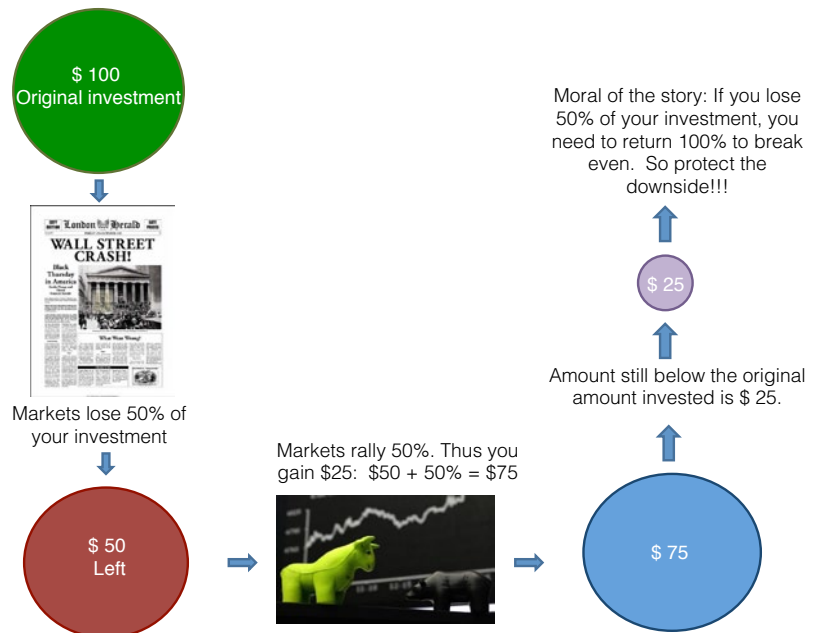
By November 2018, if all else stays equal (Ceteris Paribus), the \$100 that had been invested in the HFRI FOF Index, would be worth \$260 and the \$100 investment in the MSCI would be worth half that, at \$133.

The crux of the matter is downside protection. Even if equity markets provide great upside, which is always a great selling point, they have greater drawdowns than hedge funds. This is rarely mentioned. The flow chart below illustrates this point.

By way of an example – one invests \$100, markets crash as they did in 2008 and you lose 50%. The \$100 investment now stands at \$50. Now assume markets run by 50% as they did in 2009 - the investment would now be worth \$75 (i.e.  $\$50 \times 50\% = \$25$ . And  $\$50 + \$25 = \$75$ ).

So although markets have gained 50%, investors would still be 25% below the initial investment. Get the picture?

This leads to my conclusion - ten years on we have a clear winner. By way of a knockout it is..... hedge funds! ■



1. The 24 developed market country indices which the MSCI consist of as at June 2010 are : Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom, and the United States.
2. The MSCI World Index is a free float-adjusted market capitalisation weighted index that is designed to measure the equity market performance of developed markets ([http://www.msci.com/products/indices/international\\_equity\\_indices/definitions.html#WORLD](http://www.msci.com/products/indices/international_equity_indices/definitions.html#WORLD))
3. Estimated number of hedge funds that report to [www.hedgefundresearch.com](http://www.hedgefundresearch.com) (September 2010).
4. Fund of funds invest with multiple managers through funds or managed accounts. The strategy designs a diversified portfolio of managers with the objective of significantly lowering the risk (volatility) of investing with an individual manager.

## FUND MANAGER PROFILE: KADD



**Kevin Pretorius**

**Ali Haji**

**Danie Gouws**

**David Hancock**



**KADD Capital (Pty) Ltd**

### **How long has KADD been investing in the hedge fund industry?**

KADD was formed in August 2006. The Validus Alternative Investments Trust was launched in September 2006 and we received our first external investment in July 2007.

### **Where did you gain your investment/hedge fund experience and how long have you been in the industry?**

The team have all worked at a variety of local and foreign investment banks and were predominately based at S.I.B. (Securities Investment Bank), where Danie was the Managing Director from 1991 to 2002. It was here that the team got to trade the full range of interest rate instruments, extracting value from the South African yield curve, utilising different trading styles namely: Arbitrage, Relative Value and Directional. Before KADD was formed, the team had three successful years trading their own and part of Kagiso Trust's capital. The experience gained in these few years served us well since with a small capital base, we had to fine tune our skills, matching cash settlements and margin, whilst still trying to extract maximum value from our trade ideas.

### **What motivates you about the hedge fund industry?**

Our investment world is challenging and ever-changing and we have often at the start of a year, thought that the year could be quiet and opportunities might be few and far. However, as an emerging country there is always something happening. The hedge fund industry provides us with a platform to extract value using a variety of instruments, without the day to day noise and administrative burden that a large bank may endure. The industry also provides us the opportunity to meet and exchange views with some of the best investment minds in the country.

### **What is the KADD strategy or motto for investing?**

Extracting value, and "keep it simple" as one day you have to unwind your transactions.

### **How should risk in a hedge fund be viewed and managed?**

We view the awareness of possible changes in the value of a portfolio due to interest rate movements as the most important elements of risk management.

### **What does KADD do to differentiate itself from competitors?**

Being based in Fourways, Johannesburg, we are away from the hub of the industry mainly based in Cape Town, so we tend not to know what the other managers are doing. We do not really view other fixed

income hedge funds as competitors - the fixed income space is becoming a real force in the hedge fund industry and our hope is that investors up their allocation to fixed income.

### **Why do you think that the fixed interest hedge funds in SA have recently outperformed most other strategies?**

The interest rate market is a very large, liquid market with many different opportunity sets. 2008 / 2009 was an exceptional year in terms of market movements and our trade strategies maximised returns during this volatile period.

### **How do you view hedge fund regulation?**

Positively. Although the local industry is already highly self-regulated, a formal regulatory framework may be positive for the industry. However, regulators need to have a thorough understanding of gearing and leverage in the fixed interest industry.

### **What advice do you have for investors?**

Markets are very volatile at present and an allocation to hedge funds during times like these could be exactly what an investor's portfolio needs. South African hedge fund managers have proven themselves over the past 2 years to be more than competent in trading these volatile markets. ■